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A Two-Part Report: A and B

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Japan's Economy In High Gear

Prime Minister Noboru Takeshita had unusually good news to share with his counterparts from the other leading industrialized nations at the Toronto summit. Japan's gross national product in the first three months of 1988 rose at a real annual rate of 11.3 percent, the fastest pace in 11 years. The seasonally adjusted quarter-to-quarter gain of 2.7 percent almost equalled the U.S. growth rate of 2.9 percent for all of 1987.

The latest quarter was the third straight period of strong growth (see Table 1), but the components have been changing. While the second half of last

Table 1: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1986	FY 1987	April- June 1987	July- September 1987	October- December 1987	January- March 1988
Gross National Product	Y301,679.7 (2.6%)	Y316,610.9 (4.9%)	Y306,805.8 (0.0%)	Y313,030.0 (8.4%)	Y318,776.3 (7.5%)	Y327,402.3 (11.3%)
Personal Consumption Spending	169,195.1 (3.6%)	175,927.4 (4.0%)	173,089.9 (2.7%)	174,877.5 (4.2%)	175,663.0 (1.8%)	180,233.0 (10.8%)
Private Residential Construction	15,637.9 (10.9%)	19,368.0 (23.9%)	16,950.2 (12.5%)	18,679.1 (47.5%)	21,042.6 (61.1%)	21,250.9 (4.0%)
Private Fixed Nonresidential Investment	56,361.2 (4.5%)	62,079.0 (10.1%)	58,973.3 (7.3%)	60,554.5 (11.2%)	63,065.7 (17.6%)	65,336.6 (15.2%)
Change in Business Inventories	515.2 (*)	966.0 (*)	906.7 (*)	716.3 (*)	1,172.2 (*)	1,050.6 (*)
Government Current Expenditures	29,002.0 (6.8%)	28,779.3 (-0.8%)	28,726.6 (4.9%)	28,648.5 (-1.1%)	28,706.9 (0.8%)	29,028.8 (4.6%)
Government Fixed Investment	22,162.2 (6.6%)	24,558.9 (10.8%)	22,797.4 (6.9%)	23,496.0 (12.8%)	25,046.4 (29.1%)	26,045.3 (16.9%)
Change in Government Inventories	816.0 (*)	41.5 (*)	-1,891.6 (*)	-9.2 (*)	-163.3 (*)	452.3 (*)
Net External Sector	7,990.1 (-35.0%)	4,890.8 (-38.8%)	5,463.9 (-87.9%)	6,067.3 (52.0%)	4,242.8 (-76.1%)	4,004.8 (-20.6%)
Exports of Goods and Services and Factor Income Received	52,689.5 (-3.6%)	55,303.6 (5.0%)	52,466.1 (-7.2%)	55,981.6 (29.6%)	55,472.2 (-3.6%)	57,419.7 (14.8%)
Imports of Goods and Services and Factor Income Paid	44,699.5 (5.5%)	50,412.8 (12.8%)	47,002.2 (28.0%)	49,914.3 (27.2%)	51,229.4 (11.0%)	53,414.9 (18.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

year saw an unusually strong contribution from housing, in the latest quarter it was relatively flat, contributing a mere 0.1 percentage point to the overall 2.7 percent quarterly growth rate. This compares with a 0.8 point contribution in the October-December period. In contrast, consumer spending, the previously sluggish giant, surged forward at a 10.8 percent annual clip and contributed 1.4 percentage points. Still, its share in the total economy slipped for the third straight quarter.

The real star this time around was corporate spending, up 15.2 percent on an annual basis and contributing 0.7 percentage point to overall growth. Reflecting the continuing effects of last year's fiscal stimulus package, government spending (current expenditures, fixed investment and inventories) also rose sharply, contributing 0.6 percentage point to the rise in GNP.

In what has become a widely publicized pattern, the external sector remained stuck in reverse, pulling down the growth rate as imports expanded faster than exports. The adverse effect on the overall quarterly growth rate, however, was a mere 0.1 percentage point.

For the second straight year, the external sector was a significant drag on the economy in FY 1987 which ended in March. Overall inflation-adjusted growth was 4.9 percent, easily surpassing the government's December outlook of 3.7 percent, but the external sector knocked 1 point off the growth rate in marked contrast to the 6 point contribution of domestic growth (see Table 2).

Table 2: Components of Japan's Real Economic Growth

	<u>Total Rate</u>	<u>Domestic Component</u>	<u>External Component</u>	<u>Current Account Surplus*</u>
FY 1970	8.3%	8.9%	-0.7%	\$2.3
FY 1971	5.3	4.0	1.3	6.3
FY 1972	9.7	10.6	-0.8	6.2
FY 1973	5.3	7.5	-2.2	-3.9
FY 1974	-0.2	-2.8	2.6	-2.3
FY 1975	3.6	2.0	1.6	0.1
FY 1976	5.1	3.6	1.5	4.7
FY 1977	5.3	4.2	1.0	14.0
FY 1978	5.1	6.9	-1.8	11.9
FY 1979	5.3	4.8	0.5	-13.9
FY 1980	4.0	1.0	3.0	-7.0
FY 1981	3.3	2.1	1.2	5.9
FY 1982	3.2	2.7	0.5	9.1
FY 1983	3.7	2.1	1.5	24.2
FY 1984	5.1	3.9	1.3	37.0
FY 1985	4.4	3.7	0.8	55.0
FY 1986	2.6	4.1	-1.5	94.1
FY 1987**	4.9	6.0	-1.0	84.5

*In billions of dollars.

**Preliminary.

Source: Economic Planning Agency

Fiscal years 1986 and 1987 were the first back-to-back years since the early 1970s to combine strong domestic growth with weak net exports. Although external demand is declining rapidly as a percentage of the economy, the current account surplus remains high, especially when measured in dollars.

Despite the rapid rate of growth in the January-March period, the Economic Planning Agency and the Bank of Japan are not very worried about the economy overheating and inflation rearing its head, partly because EPA estimates that growth in the current quarter has slowed dramatically. If there is a sharp downturn, some analysts expect the government to sweeten its tax reform proposals with larger income tax cuts than currently considered (see following article).

Douglas Ostrom

Stimulative Tax Reform Package Revealed

On June 15 the Liberal Democratic Party's Tax System Research Council unveiled the results of months of negotiations: a sweeping tax reform package that would lower corporate and individual income tax rates at the national level and institute a general consumption tax. The package would also cut inheritance taxes, increase credits for dependents and senior citizens, lower securities transactions taxes, and reduce or eliminate current commodity taxes; local income taxes would be trimmed as well. The LDP and the cabinet approved the package June 16. A 120-day extraordinary Diet session will be convened July 11 to consider the reforms. Most opposition parties welcome the tax reductions but remain adamantly opposed to any major indirect tax. The Democratic Socialist Party, however, has proposed some compromises that might win its support for the overhaul.

The package envisions tax reductions of Y5.6 trillion (\$44.8 billion at Y125=\$1.00) in FY 1990, composed of changes in:

- National personal income taxes - Reducing the number of brackets April 1, 1989 from 12 to five with a top rate of 50 percent for incomes above Y20 million (\$160,000) compared with the current maximum of 60 percent for incomes over Y50 million (\$400,000). Taxpayers at the low end will also benefit (see Table 1): the bottom rate will drop to 10 percent from 10.5 percent and will apply to incomes of less than Y3 million (\$24,000) instead of Y1.5 million (\$12,000). Credits for dependents, senior citizens and handicapped people also will be increased.

- Local personal income (residence) taxes - Reducing the number of brackets and cutting the maximum rate, also effective at the start of FY 1989. Combined with the cuts at the national level, these changes will total an estimated Y3.1 trillion (\$24.8 billion).

- Corporate income taxes - Cutting the maximum corporate rate in two steps until it reaches 37.5 percent in FY 1990, compared with the present 42 percent maximum. The rate for small- and medium-sized businesses will drop from 30 percent to 28 percent (see Table 2). The LDP council projects that these changes will cost Y1.8 trillion (\$14.4 billion) in revenue.

Table 1: Impact of Tax Reform on an Average Household*

(combined national and local income taxes in thousands of yen and percent)

<u>Annual Income</u>	<u>Current Tax</u>	<u>Tax Reduction</u>	<u>Percent Reduction</u>
Y3,000	Y48	Y39	81.3%
5,000	316	85	27.0
8,000	1,040	217	20.9
10,000	1,686	289	17.2
15,000	4,053	338	8.3
20,000	6,879	551	8.0

*For tax year 1990. Based on a salaried, four-person household with one child in the 16 to 22 age group.

Source: Nihon Keizai Shimbun

Table 2: Proposed Corporate Income Taxes

(in percent)

<u>Category</u>	<u>FY 1988</u>	<u>FY 1989</u>	<u>FY 1990</u>
Regular Corporations			
Retained earnings	42%	40%	37.5%
Dividends	32	35	37.5
Small Businesses			
Retained earnings	30	29	28
Dividends	24	26	28
Special Reduced Rates*			
Retained earnings	27	27	27
Dividends	22	25	27

*For cooperative associations and other special organizations.

Source: Ministry of Finance

• Inheritance and gift taxes - Reducing the top tax rates and increasing minimum taxable amounts. Partly in response to the sharp increase in land prices over the past few years, the Tax System Research Council recommended the first significant changes in inheritance and gift taxes in 13 years. Retroactive to April 1, 1988, the top rate will be reduced to 70 percent from 75 percent on estates above Y500 million (\$4 million) and gifts above Y70 million (\$560,000). The minimum taxable estate and individual inheritance will double to Y40 million (\$320,000) and Y8 million (\$64,000), respectively. The tax-exempt minimum for surviving spouses will also be doubled. These changes are expected to reduce revenues by Y700 billion (\$5.6 billion).

In exchange for these reductions, the government hopes to raise by FY 1990 a net Y3.2 trillion (\$25.6 billion) in revenues through the following changes:

• Capital gains tax - Calculating the tax liability (at the taxpayer's discretion) by one of the following methods: 20 percent of the yield, or 1 percent of the total value of the transactions. The impact of this will be softened by lowering the securities transactions tax from 0.55 percent to 0.3 percent of the transaction value for stocks and from 0.26 percent to 0.16 percent for bonds. Combined with small changes in other personal taxes (such as tougher regulation of inheritance taxes), this should bring in an estimated Y600 billion (\$4.8 billion).

• Corporate taxes - Keeping a closer watch on corporate tax returns and eliminating some tax exemptions by FY 1990, the tax office hopes to gain Y600 billion (\$4.8 billion).

• General consumption tax - Adding a 3 percent tax on goods and services will raise an estimated Y5.4 trillion (\$43.2 billion). Firms with annual sales of less than Y30 million (\$240,000) will be exempt and those with sales under Y60 million (\$480,000) will pay a reduced rate. The following transactions will be exempt: food, medical fees paid by public insurance, tuition fees, public works projects, real estate transactions, transfers of securities, insurance, loans, exports and international postal transfers (e.g., money orders or wired funds). Items that will retain their own specific commodity taxes (such as alcoholic beverages) will also be exempt. Most commodity taxes, however, will be abolished, reducing revenues by an estimated Y3.4 trillion (\$27.2 billion). A potentially important change for non-Japanese automakers is the decision to drop the 23 percent excise tax on full-size cars and cut the tax on compact and minicars from 18.5 percent to 6 percent. A general consumption tax won over a value-added tax such as that commonly used in European countries because of the greatly reduced paperwork (see Table 3). The changes in indirect taxes will yield a net Y2 trillion (\$16 billion) in revenue.

Table 3: An Example of the Proposed 3 Percent Indirect Tax

	(in yen)				
<u>Stage:</u>	<u>Raw/Basic Materials</u>	<u>Manu- facturing</u>	<u>Distri- bution</u>	<u>Retail</u>	<u>Consumer</u>
Purchase Price:		Y20,600	Y51,500	Y72,100	Y103,000
Of which tax:		Y600	1,500	2,100	3,000
Margin:		30,000	20,000	30,000	
Total Taxable Amount:	Y20,000	50,000	70,000	100,000	
Tax:	Y600	1,500	2,100	3,000	
Sale Price:	20,600	51,500	72,100	103,000	
Net Tax:	Y600	900	600	900	3,000

Source: Nihon Keizai Shimbun

• Alcoholic beverage taxes - Dropping the grading system for sake and wine, easing the grading system for whiskey and sharply reducing the levy based on alcoholic content (see Table 4). The tax on shochu, a popular local drink, will be raised by 75 percent to reduce the gap between levies on domestic and imported spirits. The expected impact is unclear, although the changes may be revenue-neutral.

Table 4: Proposed Alcoholic Beverage Taxes

(in yen per kiloliter)

<u>Product</u>	<u>Alcohol Content</u>	<u>Current Tax</u>	<u>Proposed Tax</u>
Sake			
Special	15%	Y570,600	Y133,700
Grade 1	15	279,500	133,700
Grade 2	15	107,900	133,700
Blended Sake	15	81,600	65,700
Shochu			
Grade A	25	78,600	119,800
Grade B	25	50,900	70,800
Mirin			
Regular	13.5	74,100	21,600
Fortified	22	63,500	34,400*
Beer	--	Y239,100	208,400
Wine			
Regular	--	159,800	46,300
Above grade	--	60,400	46,300
Below grade	--	49,700	46,300
Sweetened Wine	12	117,300	85,000
Whiskey			
Special	43	2,098,100	1,055,980*
Grade 1	40	1,011,400	982,300
Grade 2	37	296,200	908,620
Other Spirits	37	361,800	331,400
Liqueur			
Regular	15	367,000	106,270*
Other	12	117,300	85,000
Miscellaneous			
Distilled	--	239,100	208,400
Mirin-type	13.5	74,100	21,600
Other	12	117,300	85,000

*Base rate; total tax will depend on actual alcohol content.

Source: Ministry of Finance

In sum, the tax reform package will be stimulative, with total tax reductions outweighing increases by Y2.4 trillion (\$19.2 billion). This is equivalent to 4.2 percent of the fiscal 1988 general account budget of Y56.7 trillion (\$453.6 billion). Since this year's budget is already 4.8 percent bigger

than FY 1987's, the proposed tax cut will insure that the public sector plays a positive role in Japan's overall economic growth at least through the end of the decade.

Prime Minister Noboru Takeshita still faces major obstacles to winning Diet approval for the tax package despite the LDP's majority. Since his predecessor came close to political disaster over tax reform, Mr. Takeshita has been carefully preparing the public for his tax package. There is now a general sense of inevitability about the need for a new indirect tax, and the prime minister is hoping that the personal and business tax cuts will make the 3 percent general consumption tax more palatable.

Opposition parties will surely try to scuttle the tax increases in the package, but Mr. Takeshita's efforts to split the opposition appear to be having some success. The Democratic Socialists are showing signs of a willingness to compromise. With the support of one opposition party, the LDP can claim that it did not ram tax reform through the Diet. A lot of wheeling and dealing can be expected between now and mid-November when the extraordinary Diet session is scheduled to end.

Jon Choy

Japan Tops Ranks Of Borrowers, Too

At first it seems contradictory. Japan is the world's biggest creditor and the United States the largest debtor, yet recently released International Monetary Fund statistics appear to put Japan first as a net borrower in 1987, with the United States the runner-up even in this apparently dubious competition. Japan's second straight first-place finish comes after years during which the United States routinely took top honors (see Table 1).

Table 1: Net Cross-Border Flow of Bank Borrowing

(in billions of dollars)

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Japan	\$8	\$-2	\$40	\$76
United States	29	32	11	51
Other Industrialized Countries	-26	-25	-69	-60
Developing Countries (excl. offshore centers)	-8	-17	--	-19
Other Transactions	-7	-22	-49	10

Source: International Monetary Fund

Of course the data do not suggest that Japan and the United States are the world's leading basket cases. Nor do they undermine Japan's status as the largest creditor. In 1987 Japan incurred the most debt to banks overseas but also had the largest net outflow when all international financial flows are considered.

Table 2 gives some details. In addition to net export earnings as reflected in the balance of payments, Japanese firms borrowed from banks abroad. Together, these funds became a source of bank lending to nonbanks overseas, outflows from nonbanks in Japan to nonbanks elsewhere, and increases in official Japanese reserves. In ordinary language, the flows among nonbanks represent Japanese purchases of real assets and securities abroad. Borrowing overseas permitted these purchases to be larger than dictated by balance of payments considerations alone. In short, the figures show Japan's emergence as a global banking center -- with institutions located in Japan pooling funds from around the world to finance other international activities. Japan is a natural for this role, given its position as the largest creditor.

Douglas Ostrom

Table 2: Changes in Japan's International Financial Situation, 1987

(in billions of dollars)

Current Account Surplus	\$87
Plus: Net borrowing from overseas banks	76
Less: Net Japanese bank lending to nonbanks abroad	26
Less: Net financial outflows among nonbanks*	94
Equals: Change in official reserves	43

*Includes errors and omissions

Source: International Monetary Fund

Tokyo Shines At Toronto Summit

The annual summit meeting of the major industrial nations are important for building allied cooperation on economic and diplomatic issues but rarely result in major policy changes. This summit, held June 19-21, in Toronto, was no exception. The majority of the political declaration focused on East-West issues, such as Soviet reforms that have opened up commerce with the communist bloc and Moscow's more flexible approach to arms control. Antiterrorism commitments made during the last five summits were reaffirmed. The declaration also established a ministerial-level task force to explore more effective ways of cracking down on the international narcotics trade.

History may show, however, that new ground was broken in terms of Japan's role in this forum. Unlike previous summits where Tokyo found itself on the defensive due to trade frictions with other participants and its burgeoning trade surplus, Japan was able to take advantage of this occasion to demonstrate to its "peers" that it recognizes its global economic stature and has begun to embrace the responsibilities attendant with this leadership role. Prime Minister Noboru Takeshita was afforded a rare opportunity to pursue a more activist strategy in promoting Japan's proposals on a variety of issues, particularly Third World debt.

Mr. Takeshita went to Toronto with an impressive array of statistics substantiating the effectiveness of Japanese government policies designed to